

**Internal Revenue Service
Appeals**

Number: **201022029**
Release Date: 6/4/2010

Date: March 8, 2010

Uniform Issue List

501.03-00

Department of the Treasury

Address any reply to:

Employer Identification Number:

Form Number: 1023

Person to Contact:

Contact Telephone Number:

Fax Number:

**Last Day to File a Petition with the United States
Tax Court:** JUN 07 2010

Certified Mail

Dear :

This is our final adverse determination as to your request for exempt status under section 501(c)(3) of the Internal Revenue Code ("Code"). Your request for tax-exempt status is denied.

If you decide to contest this determination under the declaratory judgment provisions of Code section 7428, a petition to the United States Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia must be filed within 92 days from the date this determination was mailed to you. Contact the Clerk of the appropriate court for rules for filing petitions for declaratory judgment.

You have not demonstrated that you are organized and operated exclusively for charitable, educational, or other exempt purposes and that no part of your net earnings inure to the benefit of private shareholders or individuals as required by section 501(c)(3) of the Internal Revenue Code.

You are not organized exclusively for exempt purposes because you are a limited liability company (LLC) whose members/shareholders are not limited to organizations exempt under section 501(c)(3); instead, your members/shareholders include individuals, which violates the prohibition against inurement under section 501(c)(3). In addition, the LLC fails to meet the organizational requirements of state law, because its organizing documents state it does not have any members.

You have not demonstrated that you are operated exclusively for exempt purposes because your primary activity of operating an adult-day care center is not inherently exclusively charitable in nature, but rather is comparable to carrying on a business or trade. Your services are provided for fees primarily at market rates,

you will terminate services to individuals who later become unable to pay, services are not provided substantially below costs, and no benefit is donated to charitable beneficiaries.

Contributions to your organization are not deductible under Code Section 170.

Until termination, you are required to file Federal income tax returns on form 1120 for any years, which are still open under the statute of limitations. You should file any returns due for these years or later years with ****. Processing of income tax returns will not be delayed because you have filed a petition for a declaratory judgment under Code section 7428.

We will notify the appropriate State officials of this action, as required by Code section 6104(c).

If you have questions about this letter, you may write to or call the contact person whose name, telephone number, and IRS address are shown on the first page of this letter. If you write, please include your telephone number, the best time for us to call you if we need more information, and a copy of this letter to help us identify your account. Keep the original letter for your records. If you prefer to call and the telephone number is outside your local calling area, there will be a long distance charge to you.

The contact person identified on the front of this letter can access your tax information and help you get answers. You also have the right to contact the office of the Taxpayer Advocate. You can call 1-877-777-4778 and ask for Taxpayer Advocate assistance. Or you can contact the Taxpayer Advocate for the IRS office that issued this notice of deficiency by calling **** or writing to ****. Taxpayer Advocate assistance is not a substitute for established IRS procedures such as the formal appeals process. The Taxpayer Advocate is not able to reverse legally correct tax determinations, nor extend the time fixed by law that you have to file a petition in the U.S. Tax Court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling.

Sincerely yours,

/s/
Appeals Team Manager



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Date: MAR 8 2010

Contact Person:

Identification Number:

Contact Number:

FAX Number:

Employer Identification Number:

Legend:

M = Applicant
N = Member
O = Member
P = Director
Q = Director
R = Director
x = state
a = date
b = date
c = date

UIL Index:

501.03-00
501.03-05
501.03-30

Dear :

We have considered your application for recognition of exemption from Federal income tax under Internal Revenue Code section 501(a). Based on the information provided, we have concluded that you do not qualify for exemption under Code section 501(c)(3). The basis for our conclusion is set forth below.

Issue:

Does M qualify for federal tax exemption under IRC 501(c)(3) as a charitable organization?

Facts:

Organization:

M incorporated in the state of x on date a, under the x Limited Liability Company Act. M listed N and O as the individual members of M. The Articles stated that M will not have managers, and that management of the company is reserved to the members. N and O were also listed as the organizers of M.

Letter 4036 (CG) (11-2005)
Catalog Number 47630W

On date b, N and O filed a Certificate of Amendment for M. Article 4(a) stated that M is organized exclusively for charitable, religious, educational, and scientific purposes. The specific purpose is to provide adult day health care to enable functionally impaired individuals to reside in a supportive home environment, rather than in nursing home care; to maintain clients at the highest level of functioning possible; to improve the quality of life for the participants among their peers and to provide support for their families and other caregivers.

Article 6 stated that the amendments were approved by all members of the limited liability company in accordance with section H of Article 2.23 of the Act.

On date c, N and O filed additional amended Articles that contained the following provisions:

Article 7 stated that "The shareholders hereby form a Limited Liability Company to further charitable purposes subject to the provisions of the Limited Liability Company Act as currently in effect as of this date. M's organized document provisions are consistent with LLC laws, and are enforceable at law and at equity."

Article 7 stated that "the company shall continue for a period perpetual unless dissolved by (a) any event which makes it unlawful for the business of the company to be carried on by the shareholders or (b) the death, resignation, expulsion, bankruptcy, retirement of a shareholder or of the occurrence of any other event that terminates the continued organizational structure of the company, or (c) any other event causing a dissolution of a Limited Liability Company under the laws of the State of x."

Article 9 states that M has no members, nor will it have a membership body. The management and administration of the company will be directed by the two organizing shareholders (N and O). The shareholders possess no ownership rights, only voting rights. The company will undertake no additional shareholders. Total voting shares authorized and issued are 100 voting shares – 51 belonging to N and 49 to O.

Article 10 expanded M's Board of Directors to include P, Q and R.

Article 11 appoints N as the Chief Executive Officer, and O as the Executive Shareholder. These two officers are authorized to make all decisions relating to the sale, development, lease or other disposition of the company's assets; the purchase or other acquisition of other assets of all kinds; management of all or any part of the company's assets; borrowing money on the company's assets; the prepayment, refinancing or extension of any loan affecting the company's assets; the compromise or release of any of the company's claims or debts; and the employment of persons, firms or corporations for the operation and management of the company's business.

Article 11 authorizes these officers to execute or deliver all contracts, conveyances, assignments, and contracts; all checks, drafts and other orders for payment; all promissory notes and loans; and all other instruments of any kind relating to the company's assets.

Article 12 provides that the salaries of the officers shall be adjusted from time to time by the Board of Directors.

Article 16 provides that upon dissolution, any assets remaining after payment of liabilities shall be distributed exclusively to exempt organizations for exempt purposes within the meaning of IRC 501(c)(3).

Article 17a provides that the company will not pay dividends, and that no part of the earnings shall inure to the benefit of its Board of Directors, officers, or other persons, except as reasonable compensation for services rendered.

Article 18 prohibits M from merging with or converting into a for-profit entity, or purchasing or acquiring for-profit entities. M's assets cannot be transferred to any other organizations, except to organizations exempt under IRC 501(c)(3) or governmental units or instrumentalities in exchange for fair market value.

These amended articles stated that "the company has no members, has not received any capital, and has not commenced business. In accordance with Section G of Article 2.23 of the Act, the amendments to the articles of organization were approved by a majority of the initial managers named in the articles of organization."

A Limited Liability Company Agreement signed and dated by N and O on date b was amended, signed and dated on date c. This agreement basically restated the provisions of the amended Articles, and again stated that M has no members, only two shareholders (N and O).

M filed Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, on November , 20 . N and O were listed as "Member/Employee" with projected salaries of \$4500 each.

In correspondence dated June , 20 and July , 20 , IRS notified M that exemption under IRC 501(c)(3) is granted to a limited liability company *only if* all of its members are themselves organizations that are exempt under 501(c)(3). In a response received by IRS on July , 20 , M claimed that it has no members that that N and O are its shareholders.

On July , 20 , IRS again notified M that exemption under IRC 501(c)(3) is granted to an LLC only if all of its members are themselves organizations that are exempt under 501(c)(3). On August 15, M responded by quoting the charitable purpose clause of its amended Articles of Incorporation (Article 4a). M reiterated that it has no members.

In correspondence dated August , 20 and September , 20 , IRS outlines an acceptable course of action that could lead to M receiving exemption – i.e. re-formation as a regular corporation.

M's organizational structure was discussed with O in a phone call on September , 20 . In a letter dated October , 20 , N requested that M's case be reopened, stating that it is not a membership organization.

In a letter dated October , 20 , but faxed to IRS on February , 20 , N stated "I don't know if you are familiar with Spiritual things, (Things having to do with God); however, I will attempt to explain to you why we choose not to be M, :

Where M, LLC is concerned, we must be in compliance to the will of the " . He has ordained that this facility be M, LLC. We dare not submit to the will of men to make it M, , for it is a mandate on our lives that we follow His instructions. This is our solemn and only reason for pursuing M, LLC. Except the Lord builds the house, men labor in vain. Psalms 127:1. We are striving to obey our God, nothing more or nothing less."

Operations:

M's planned activity is providing "adult day care service for a growing number of people who have some ability for self-care and do not require constant medical attention, especially senior citizens and handicapped individual." M plans to apply for a Rural Development Grant to build a facility on land transferred to M by N and O.

Revenue from gifts, grants and contributions were projected to be approximately \$200,000 in 20 and 20 . An unusual grant of \$ was expected in 20 . Additional revenue was expected to come from *private functions, weddings, family reunions, business meetings, daily lunch, transportation, nutrition education and computer education*. These latter activities (in italics) were later disavowed as "not necessary for the maintenance and upkeep of ' (correspondence received July , 20).

M submitted a schedule of fees to be charged on an hourly or monthly basis. M provided the following information about who would be eligible to receive services, and the sources of fees:

- The original Form 1023 application indicated that "most clients are recipients %, % private pay, % veterans" (Schedule F).
- Part IX of Form 1023 referenced a system of paying "Associates" who would receive "free service".
- Schedule F, Section II listed possible groups of clients who would be unsubsidized by the applicant (e.g. Medicaid patients, private pay, long term care, veterans)

Later correspondence from M included further inconsistent information about possible clients and sources of funds:

- A flyer advertised "Free services to who qualify" with no explanation. (correspondence received July , 20)
- Correspondence dated August , 20 stated that "Fees will not be provided below cost"
- Correspondence dated August , 2007 stated that "Associates were to pay fees for benefits, such as free service, plaques, recognition from the facility".

Law:

A "person" who can function as a member of an LLC includes a corporation, organization,

government or governmental subdivision or agency, business trust, estate, trust, partnership, association, and any other legal entity (Government Code Section 311.005). Generally, the liability of the members is limited to their investment and they may enjoy the pass-through tax treatment afforded to partners in a partnership. The members are considered the owners of the LLC.

The Business Organization Code (BOC) was enacted in 2003 to be effective on January , 20 . It codified eleven statutes, including the Limited Liability Company Act. The BOC applies to all new corporations, partnerships, limited liability companies and other domestic filing entities formed on and after that date. Existing domestic and foreign entities will automatically become subject to the BOC on January , 20 , unless those entities elect early adoption of the BOC by filing an early adoption statement with the secretary of state.

Title 3, Section 101.101 of the Business Organization Code states that a limited liability company must have at least one member. This applies to all LLCs formed on or after January , 20 . LLCs formed before this date have until January , 20 to comply with this requirement. They also have the option to comply before January , 20 .

A corporation formed before January , 20 may file amendments to its organizing document, but only if it agrees to adopt the Business Organization Code (). Unless the LLC adopts the , it would not be allowed to amend the Articles of Formation to include a nonprofit purpose.

Section 501(c)(3) of the Internal Revenue Code exempts from federal income tax corporations, and any community chest, fund, or foundation, **organized** and **operated** exclusively for religious or other exempt purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(a)-1(a)(2) of the Income Tax Regulations provides that an organization is not exempt from tax merely because it is not organized and operated for profit. In order to establish its exemption, it is necessary that every such organization claiming exemption file an application.

Section 1.501(a)-1(b)(2) of the regulations provides that the Commissioner may require (from an organization applying for exemption) any additional information deemed necessary for a proper determination of whether a particular organization is exempt under section 501(a) of the Code, and when deemed advisable in the interest of an efficient administration of the internal revenue laws, he may in the cases of particular types of organizations prescribe the form in which the proof of exemption shall be furnished.

Section 1.501(a)-1(c) of the regulations defines a "private shareholder or individual" as a person having a personal and private interest in the activities of the organization.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization "operates exclusively" for 501(c)(3) purposes only if it engages primarily in activities that accomplish such

purposes. It does not operate exclusively for 501(c)(3) purposes if more than an insubstantial part of its activities does not further such purposes.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for exempt purposes if its net earnings inure in whole or part to the benefit of private shareholders or individuals.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for exempt purposes under Section 501(c)(3) of the Code unless it serves a public rather than a private interest. Thus, an organization must establish that it is not organized or operated for the benefit of private interests, such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled by such private interests.

Rev. Rul. 69-528, 1969-2 C.B. 127, held not exempt under section 501(a) of the Code an organization formed to provide investment services for a fee exclusively to 501(c)(3) organizations. The Service reasoned that providing investment services on a regular basis for a fee is a business ordinarily carried on for profit and would constitute unrelated business if conducted by one tax-exempt organization for other tax-exempt organizations.

Rev. Rul. 72-369, 1972-2 C.B. 245, held not exempt under section 501(c)(3) of the Code an organization formed to provide managerial and consulting services at cost to unrelated 501(c)(3) organizations. The Service reasoned that providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit.

In Rev. Rul. 77-4, 1977-1 C.B. 141, an organization whose only activities were preparing and publishing a newspaper of local, national, and international news articles with an ethnic emphasis, soliciting advertising and selling subscriptions to that newspaper in a manner indistinguishable from ordinary commercial publishing practices was held to be not operated exclusively for charitable and educational purposes and did not qualify for exemption.

University of Maryland Physicians, P.A. v. Commissioner, T.C.M. 1981-23, held exempt under section 501(c)(3) of the Code a professional service corporation established by clinical departments of a teaching hospital for administrative efficiencies in collecting professional fees. Each shareholder was a hospital staff physician and faculty member of the affiliated school. The court accepted the corporation's for-profit status because that was the only kind of corporation permitted to practice medicine in the State.

Organizations described in section 501(c)(3) of the Code, whether corporations, associations, or trusts, generally are organized as nonprofit or charitable organizations. In the University of Maryland case, the court recognized exemption of the entity, organized under for-profit laws, under the compelling circumstance that the organization could not otherwise practice medicine, a recognized charitable activity.

In United States v. Wells Fargo Bank, 485 U.S. 351, 108 S. Ct. 1199 (1990) the Court held that an organization must prove unambiguously that it qualifies for tax exemption.

Harding Hospital, Inc. v. United States, 505 F.2d 1068 (1974), holds that an organization seeking a ruling as to recognition of its tax exempt status has the burden of proving that it satisfies the requirements of the particular exemption statute. Whether an organization has satisfied the operational test is a question of fact.

In Federated Pharmacy Services, Inc. v. Commissioner, 72 T.C. 687 (1979), the court upheld the Commissioner's denial of exemption under section 501(c)(3) of the Code. The organization was organized to operate a pharmacy to sell drugs at discount prices to elderly and handicapped persons. It had no commitment to use excess receipts to provide drugs for free or below cost to the elderly or handicapped. The organization served elderly and handicapped persons almost exclusively, and did not sell toiletry articles, magazines, cards, or other items normally sold by for-profit pharmacies. The organization's board consisted of community leaders, none of whom obtained any personal financial benefit from participation. The organization used the services of volunteers instead of paid employees. All gifts were used for the benefit of financially distressed senior citizens who, because of catastrophic illness or accident, incurred large prescription drug bills. The court reasoned that the organization operated its business primarily for commercial purposes, in competition with for-profit drug stores. The mere fact that products sold by the organization were helpful to health did not necessarily entitle it to exemption under section 501(c)(3).

Several courts have considered whether services were provided "substantially below cost" within the meaning of section 501(m)(3)(A) of the Code. Paratransit Insurance Corp. v. Commissioner, 102 T.C. 745 (1994) held that annual percentages (of charges as a percentage of expenses) of 60%, 80% and 84% were too high. Nonprofits' Insurance Alliance of California v. Commissioner, 32 Fed. Cl. 277 (1994) held percentages of 47% (in a 2-month year), 65% and 78% to be unacceptably high.

Analysis:

Organizational Test:

As stated earlier, IRC 501(c)(3) requires that an organization must be both organized and operated for charitable purposes in order to qualify for federal tax exemption.

Limited Liability Companies are comparable to for-profit corporations in that the member-owners control the organization and have the potential right to receive distributions of the LLC's earnings and other assets, upon dissolution, if not earlier.

Tax exemption under IRC 501(c)(3) is available to limited liability companies that have members (i.e. owners) that are themselves organizations that are exempt under IRC 501(c)(3). This is a courtesy that the Service extends to exempt organizations. It is not available to LLCs that have members who are individuals, because the individuals would control (and own) the LLC. This is inconsistent with exemption under IRC 501.

Although M claims that it has no members and is not a membership organization, state law requires LLCs to have at least one member. M's default members are N and O. Although

Letter 4036 (CG) (11-2005)
Catalog Number 47630W

M's governing documents purport to guard against distributions to non-501(c)(3) members, such members may be entitled to distributions under the laws applicable to LLCs in . The IRS cannot depend on state laws to guarantee that distributions will not inure to individuals.

While N and O were given ample opportunity to change the organizational structure of M, or to explore the requirements for finding an exempt owner for M, they consistently refused to do so. As a result, M does not meet the organizational test, and does not qualify for tax exemption under IRC 501(c)(3).

Operational Test:

There is much in M's application that is consistent with federal tax exemption. M is planning to provide services to the handicapped and elderly. M expanded its Board of Directors to include a majority of unrelated, uncompensated individuals. In addition, N deeded the facility for the property to M.

In spite of the somewhat inconsistent information presented, the totality of statements made by M during the development of this case indicate that services will be provided primarily for fees. There are no plans for a sliding fee scale and services will not be provided substantially below cost. The clients will be members of one or more charitable classes (i.e. the elderly or handicapped), but there is no "donative element". Services are being sold primarily at fair market rates, and nothing is being given (i.e. donated) to the charitable beneficiaries.

M is similar to the organizations described in Revenue Rulings 69-528, 72-369 and 77-4. These rulings described organizations that provided services and conducted activities on terms ordinarily seen in for-profit businesses. Based on the facts and circumstances M has presented, it appears M will operate a commercial business as an end in itself. M has a paid staff, and no free or subsidized services are provided.

This is similar to the organization described in Federated Pharmacy Services (supra). In that case, the organization was essentially structured as a commercial activity. The fact that health services were provided was insufficient to warrant exemption.

Unlike the organization described in University of Maryland v. Commissioner (supra), there is no requirement that M structures its business in this way.

In addition, M has not provided unambiguous explanations of why it qualifies for tax exemption (U.S. Bank v. Wells Fargo Bank; Harding Hospital v. U.S.). Statements were inconsistent and incomplete, even after several exchanges of correspondence.

Accordingly, M has not met the operational test as described in IRC 501(c)(3) and sections 1.501(c)(3)-1(c) and 1(d) of the Income Tax Regulations.

Determination:

M does not meet the organizational requirements under IRC 501(c)(3) because its members are individuals, and not exempt organizations.

M also does not meet the operational requirements under IRC 501(c)(3) because the manner in which it plans to operate is commercial in nature.

Accordingly, M does not meet the requirements for federal tax exemption under IRC 501(c)(3).

Contributions to M are not deductible under section 170 of the Code.

You have the right to file a protest if you believe this determination is incorrect. To protest, you must submit a statement of your views and fully explain your reasoning. You must submit the statement, signed by one of your officers, within 30 days from the date of this letter. We will consider your statement and decide if the information affects our determination. If your statement does not provide a basis to reconsider our determination, we will forward your case to our Appeals Office. You can find more information about the role of the Appeals Office in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*.

Types of information that should be included in your appeal can be found on page 2 of Publication 892, under the heading "Regional Office Appeal". The statement of facts (item 4) must be declared true under penalties of perjury. This may be done by adding to the appeal the following signed declaration:

"Under penalties of perjury, I declare that I have examined the statement of facts presented in this appeal and in any accompanying schedules and statements and, to the best of my knowledge and belief, they are true, correct, and complete."

Your appeal will be considered incomplete without this statement.

If an organization's representative submits the appeal, a substitute declaration must be included stating that the representative prepared the appeal and accompanying documents; and whether the representative knows personally that the statements of facts contained in the appeal and accompanying documents are true and correct.

An attorney, certified public accountant, or an individual enrolled to practice before the Internal Revenue Service may represent you during the appeal process. If you want representation during the appeal process, you must file a proper power of attorney, Form 2848, *Power of Attorney and Declaration of Representative*, if you have not already done so. You can find more information about representation in Publication 947, *Practice Before the IRS and Power of Attorney*. All forms and publications mentioned in this letter can be found at www.irs.gov, Forms and Publications.

If you do not file a protest within 30 days, you will not be able to file a suit for declaratory judgment in court because the Internal Revenue Service (IRS) will consider the failure to appeal as a failure to exhaust available administrative remedies. Code section 7428(b)(2) provides, in

Letter 4036 (CG) (11-2005)
Catalog Number 47630W

part, that a declaratory judgment or decree shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted all of the administrative remedies available to it within the IRS.

If you do not intend to protest this determination, you do not need to take any further action. If we do not hear from you within 30 days, we will issue a final adverse determination letter. That letter will provide information about filing tax returns and other matters.

Please send your protest statement, Form 2848, and any supporting documents to the applicable address:

Mail to:

Internal Revenue Service
EO Determinations Quality Assurance
Room 7-008
P.O. Box 2508
Cincinnati, OH 45201

Deliver to:

Internal Revenue Service
EO Determinations Quality Assurance
550 Main Street, Room 7-008
Cincinnati, OH 45202

You may fax your statement using the fax number shown in the heading of this letter. If you fax your statement, please call the person identified in the heading of this letter to confirm that he or she received your fax.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Robert Choi
Director, Exempt Organizations
Rulings & Agreements